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In the Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

- v. -

FEDERAL NATIONAL MORTGAGE ASSOCIATION

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

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QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

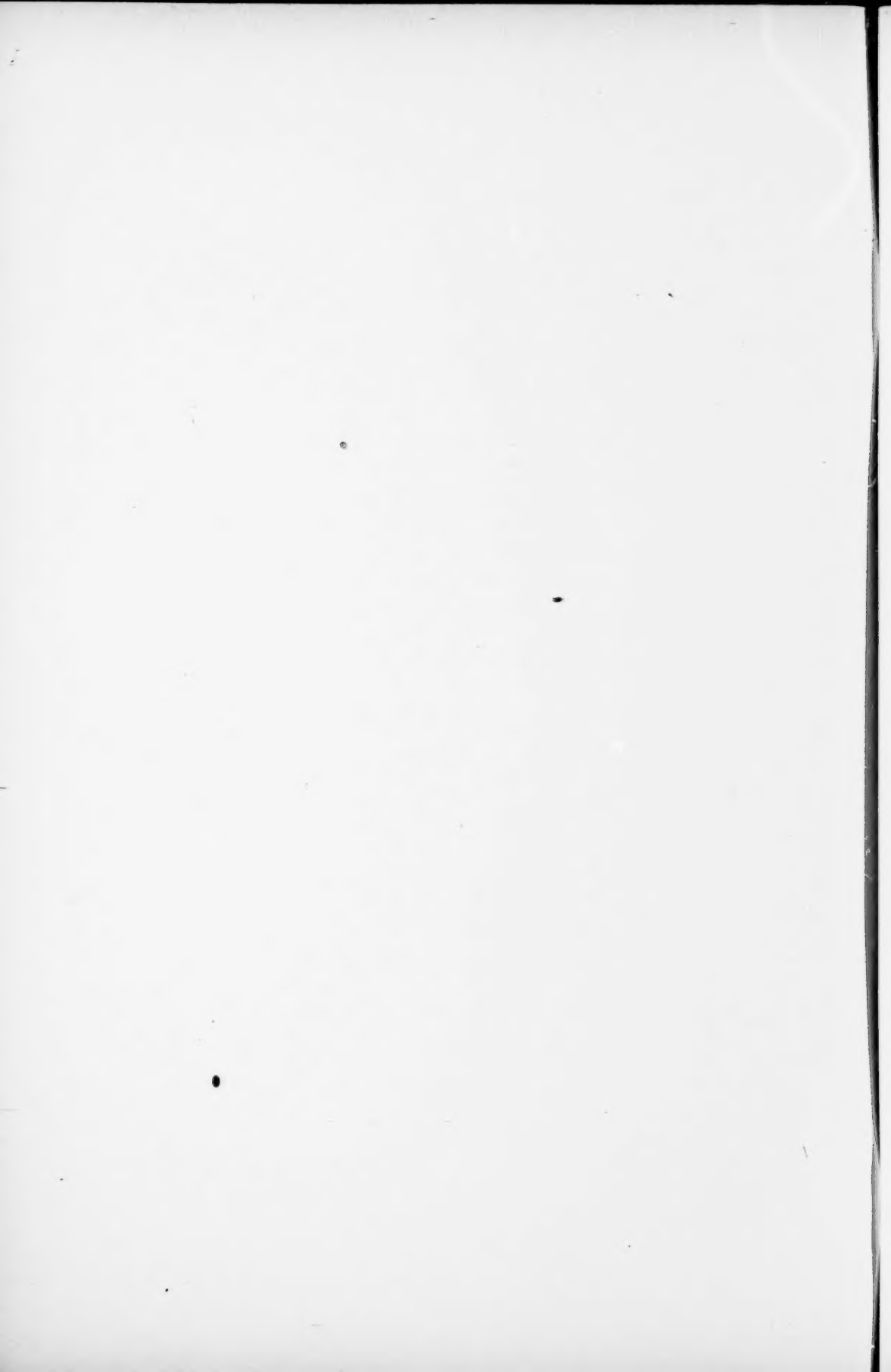


TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutory provisions and regulation involved	2
Statement	2
Reasons for granting the petition	7
Conclusion	8
Appendix A	1a
Appendix B	20a
Appendix C	53a

TABLE OF AUTHORITIES

Cases:

<i>Cottage Savings Ass'n v. Commissioner</i> , 90 T.C. 372 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989), petition for cert. pending, No. 89-1965	4-5, 7
<i>San Antonio Savings Ass'n v. Commissioner</i> , 887 F.2d 577 (5th Cir. 1989), petition for cert. pending, No. 89-1928	4, 6

Statutes and regulation:

Internal Revenue Code of 1954 (26 U.S.C. (1982)):	
§ 165	2, 6, 7, 53a
§ 1001	2, 53a-54a
12 U.S.C. 1716(a)	2
Treas. Reg. § 1.1001-1(a) (26 C.F.R.)	2, 54a-55a



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FOR THE DISTRICT OF COLUMBIA CIRCUIT**

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-19a) is reported at 896 F.2d 580. The opinion of the Tax Court (App., *infra*, 20a-52a) is reported at 90 T.C. 405.

JURISDICTION

The judgment of the court of appeals was entered on February 20, 1990. On May 9, 1990, Chief Justice Rehnquist extended the time within which to file a petition for a writ of certiorari to and including June 20, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 165 and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set out in a statutory appendix (App., *infra*, 53a-55a).

STATEMENT

1. Respondent was originally established in 1938 as an agency of the government. In 1968, it was transformed into a for-profit, privately owned corporation that is subject to regulation by the Department of Housing and Urban Development. Respondent has a congressional mandate to "provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." 12 U.S.C. 1716(a). It advances this goal of providing liquidity for mortgage investments primarily by purchasing mortgages from lenders, using funds it acquires by issuing stock and debt securities. Respondent's mortgage purchases have made it the largest investor in home mortgages in the United States. App., *infra*, 2a, 22a-23a.

In the early 1980s, respondent's mortgage loan portfolio included many fixed-rate, long-term home mortgage loans that had been issued at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. App., *infra*, 2a.

For respondent, like other financial institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A dis-

position of the loans would enable respondent to realize for tax purposes the loss that resulted from these market changes; it could then utilize the resulting loss deductions to offset current taxable income and produce loss carry-backs that would generate tax refunds from prior years. App., *infra*, 3a. For the many savings institutions holding older, low-interest loans, however, there was a problem with disposing of the loans. Most of the savings institutions with which respondent dealt were regulated by the Federal Home Loan Bank Board (Bank Board). *Id.* at 25a. Many of these savings institutions were in such precarious financial condition that a sale of the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements, raising the prospect of closure by the Bank Board. *Id.* at 3a, 25a-26a.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Memorandum R-49 established a list of criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.¹ The admitted objective of Memoran-

¹ Memorandum R-49 specifically provided in part (App., *infra*, 27a; C.A. App. 10):

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

dum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. See App., *infra*, 26a-27a; *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577, 579-580 (5th Cir. 1989), petition for cert. pending, No. 89-1928.²

2. In 1980 and 1981, respondent engaged in 71 transactions with one or more of 50 different financial institutions in which respondent, in effect, exchanged a package of 90% participation interests in a group of mortgage loans for a package of 90% participation interests in a group of mortgage loans held by the other institution.³

-
1. involve single-family residential mortgages,
 2. be of similar type (e.g., conventionals for conventionals),
 3. have the same stated terms to maturity (e.g., 30 years),
 4. have identical stated interest rates,
 5. have similar seasoning (i.e., remaining terms to maturity),
 6. have aggregate principal amounts within the lesser of 2½% or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
 7. be sold without recourse,
 8. have similar fair market values,
 9. have similar loan-to-value ratios at the time of the reciprocal sale, and
 10. have all security properties for both sides of the transaction in the same state.

² A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." See *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d at 580.

³ Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. See *Cottage Savings Ass'n v.*

The loans involved in each transaction were “substantially identical” according to the criteria set forth in the Bank Board’s Memorandum R-49.⁴ Respondent selected the loans to be exchanged by running a computer analysis of its portfolio to find loans that would match, according to the Memorandum R-49 criteria, the loans that other lenders proposed to swap. App., *infra*, 3a-4a, 28a-29a.⁵ Respondent performed no “underwriting” of the loans it was to receive, *i.e.*, it did not investigate individual loan files, employment and credit histories of the individual borrowers, or the underlying value of the property securing the individual loans. See *id.* at 30a n.11; C.A. App. 414. The pricing or valuation of all of the loans was established by applying a common discount factor based on then-current interest rates to all of the loans on each side of each transaction. C.A. App. 414-415.

Each transaction was consummated in the form of a “reciprocal sale” by conveyance of the 90% participation interests together with a simultaneous transfer of money by both parties in the amount of the fair market value of the interests acquired. App., *infra*, 29a. Respondent claimed deductions for losses on the transactions for the years 1980 and 1981 in the amounts of \$194,573,659 and \$70,042,179,

Commissioner, 90 T.C. 372, 381 (1988), rev’d, 890 F.2d 848 (6th Cir. 1989), petition for cert. pending, No. 89-1965.

⁴ The mortgages also satisfied four additional criteria imposed by respondent. These requirements related primarily to the payment history of the loans and were designed to establish minimum quality standards for the exchanged loans. App., *infra*, 27a-28a.

⁵ In addition, the computer analysis was designed to give preference to receiving loans with urban postal zip codes and transferring loans that lacked urban zip codes, because respondent had been criticized by the Secretary of Housing and Urban Development for having insufficient holdings of urban mortgages. App., *infra*, 29a, 32a-33a.

respectively (*id.* at 4a). Respondent did not report any loss for financial accounting purposes (*id.* at 36a).

3. On audit, the Commissioner determined that respondent was not entitled to its claimed deductions for losses on the mortgage exchange transactions. Respondent sought redetermination of the resulting income tax deficiencies in the Tax Court. App., *infra*, 2a, 4a. After a trial, the Tax Court held for respondent on this issue (*id.* at 42a-48a).⁶

The Commissioner's primary argument was that a loss is "realized" for tax purposes on an exchange of property only if the exchanged properties are "materially different" and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. The Tax Court concluded that the loans taxpayer transferred were "materially different" from the loans it received because the loans had different borrowers and were secured by different collateral (App., *infra*, 43a-45a). The Tax Court also rejected the Commissioner's argument that, because the mortgage exchange lacked economic substance, deduction of the loss was not authorized by Section 165 of the Internal Revenue Code (26 U.S.C.) (App., *infra*, 47a-48a).⁶

The court of appeals affirmed (App., *infra*, 1a-19a). Relying heavily on the Fifth Circuit's recent decision in *San Antonio Savings Ass'n v. Commissioner*, *supra*, the

⁶ The litigation in the Tax Court also involved a second, distinct issue. Respondent had also entered into certain "Resale/Refinance" transactions in order to improve its financial position in the wake of the interest rate changes of the early 1980s. The Commissioner had disallowed loss deductions claimed by respondent as a result of these transactions, which were entirely unrelated to the Memorandum R-49 transactions in issue here. The Tax Court sustained the disallowance of those deductions (App., *infra*, 48a-52a), and the court of appeals affirmed that ruling (*id.* at 9a-19a).

court held that a financial institution realizes a deductible loss on a Memorandum R-49 mortgage exchange transaction (App., *infra*, 5a-9a). The court specifically noted that the Fifth Circuit and the Sixth Circuit (see *Cottage Savings Ass'n v. Commissioner*, 890 F.2d 848 (6th Cir. 1989), petition for cert. pending, No. 89-1965) had reached contrary conclusions on this issue, and stated that the Fifth Circuit's decision in *San Antonio* "provides the correct evaluation of the tax consequences" of an R-49 transaction (App., *infra*, 5a). Thus, like the Fifth Circuit, the court of appeals concluded that in order for a loss on an exchange to be realized, "the property exchanged must be materially different" (*id.* at 6a), but it proceeded to hold that the loans exchanged here were materially different because the differences in obligors and the property securing the loans "foreclose any argument that the exchanged mortgages were identical" (*id.* at 7a-8a). The court also rejected the Commissioner's argument that the transactions lacked economic substance and therefore the losses were not deductible under Section 165 (App., *infra*, 8a-9a).

REASONS FOR GRANTING THE PETITION

This case presents the same question that is presented in three petitions pending from the decisions of the Fifth Circuit that were relied upon by the court below—*United States v. Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926 (Question 1); *United States v. First Federal Savings and Loan Ass'n*, No. 89-1927; *Commissioner v. San Antonio Savings Ass'n and Subsidiaries (Resolution Trust Corporation, Receiver)*, No. 89-1928—namely, whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans. As we explain in detail in our petition in *Centennial*, review of this question by

this Court is warranted because there exists a square conflict in the circuits and the issue is of considerable importance to the administration of the federal tax laws.⁷ We have accordingly urged that the Court grant plenary review in *Centennial* and in *First Federal* (see *Centennial* Pet. 13 n.10). Because the question presented here is the same as that already presented in *First Federal* and in *Centennial*, we believe that there is no need for the Court to grant plenary review in this case as well but that it would be appropriate for the Court to hold this case pending the outcome in *Centennial* and *First Federal*.

CONCLUSION

The petition for a writ of certiorari should be disposed of as appropriate in light of this Court's disposition of *United States v. Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926, and *United States v. First Federal Savings & Loan Ass'n*, No. 89-1927.

Respectfully submitted.

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⁷ We are supplying respondent's counsel with copies of our petitions in *Centennial*, *First Federal*, and *San Antonio*.

*The Solicitor General is disqualified in this case.

APPENDIX A

UNITED STATES COURTS OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Nos. 88-1827, 88-1853

FEDERAL NATIONAL MORTGAGE ASSOCIATION,
APPELLANT/CROSS-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
APPELLEE/CROSS-APPELLANT

APPEAL FROM THE UNITED STATES TAX COURT

[Filed Feb. 20, 1980]

Before: MIKVA and RUTH B. GINSBURG, Circuit Judges,
and ROBINSON, Senior Circuit Judge.

MIKVA, *Circuit Judge*: Federal National Mortgage Association ("FNMA") was severely impacted by the dramatic rise in interest rates in the late 1970s. As a result, FNMA entered into two types of mortgage transactions in the early 1980s through which it sought to improve its economic standing. The Resale/Refinance program was designed to replace uneconomical low-interest mortgages in FNMA's portfolio with higher-interest mortgages. The

Concurrent Mortgage Sales program ("CMS") was structured to allow FNMA to recognize losses in its mortgage portfolio caused by the rising interest rates.

The Commissioner of Internal Revenue (the "Commissioner") disallowed losses that FNMA claimed from both Resale/Refinance and CMS transactions, and FNMA challenged the Commissioner's deficiency determination of over \$24 million in the United States Tax Court. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 90 T.C. 405 (1988). In a decision reviewed by the full court with no separate opinions, the Tax Court upheld the Commissioner's disallowance of the losses from the Resale/Refinance program but rejected his decision with respect to the CMS transactions. The taxpayer appeals the former ruling and the Commissioner cross-appeals the latter. We affirm the Tax Court's decision.

I

FNMA was originally established as a government agency but became a privately owned, for-profit corporation in 1968. FNMA is subject to regulation by the Secretary of HUD. FNMA's primary function is to provide liquidity for mortgage investments, which it accomplishes mainly by purchasing mortgages from lenders with funds that FNMA generates by issuing stock and debt securities.

In the early 1980s, FNMA's portfolio consisted of many long-term, fixed-rate mortgages which had decreased substantially in value because of the enormous increase in interest rates since FNMA had purchased these mortgages. By 1981, FNMA was paying more interest on the debt it used to carry the mortgages in its portfolio than it was earning from the mortgages. In order to improve its financial standing, FNMA entered the two types of transactions at issue in this appeal.

II

A. The CMS Transactions**1. Background**

Because of the decrease in value of FNMA's portfolio mortgages, FNMA had a strong incentive in the early 1980s to dispose of these mortgages and recognize the tax losses it had incurred. Many financial institutions—and particularly savings and loan institutions—were similarly burdened with long-term mortgages that had been devalued by the rise in interest rates. These financial institutions desired the tax losses that would be recognized in a disposition of the below-market mortgages they were carrying but would have been at risk of closure by the Federal Home Loan Bank Board ("FHLBB") if they had to recognize these losses for reporting purposes. In order to address this situation, the FHLBB issued Memorandum R-49 ("R-49") on June 27, 1980, in which it outlined criteria for mortgage exchanges. Exchanges carried out pursuant to these criteria would enable the lenders to recognize for tax purposes the losses that they had suffered in their portfolios while freeing these lenders from the duty to report such losses for regulatory accounting purposes.

In 1980 and 1981, FNMA engaged in 71 different mortgage exchange transactions; in each, FNMA and one of 50 unrelated lenders exchanged 90-percent undivided participation interests in two groups of home mortgages. Although FNMA is not governed by the FHLBB, most of the lenders with which FNMA exchanged mortgages are subject to FHLBB regulation. Therefore, the mortgage exchanges were designed to comply with the R-49 criteria. FNMA computer-sorted the mortgages that lenders proposed to swap and FNMA's own mortgages in order to generate mortgage packages that complied with R-49 and

FNMA's own exchange criteria. Additionally, FNMA programmed its computer to replace mortgages on rural property with mortgages on urban property to the extent possible. As a result of these exchanges, FNMA claimed losses of \$194,573,659 in 1980 and \$70,042,179 in 1981. The Commissioner disallowed the deduction of these losses.

In response to FNMA's petition, the Tax Court held that FNMA had realized recognizable losses from its CMS exchanges in 1981 and 1982. In reaching this conclusion, the Tax Court rejected the Commissioner's argument that the mortgages FNMA received in the CMS transaction did not differ materially from the mortgages that it surrendered and, therefore, FNMA did not sustain any recognizable loss. The Tax Court based its conclusion on the following significant differences in the mortgages exchanged: the mortgages FNMA received had different obligors than the mortgages it exchanged; the real properties securing the respective mortgages were different; and the geographic distribution of the real properties securing the mortgages varied. The Tax Court deemed it a confirmation of "material difference" that the mortgages had, in fact, performed differently following the exchanges.

The Tax Court also rejected the Commissioner's argument that Internal Revenue Code ("IRC") § 1091's "substantial identity" rule precludes the recognition of losses realized by FNMA, concluding that—for the reasons stated above—the mortgages exchanged were substantially different.

Finally, the Tax Court disposed of the Commissioner's contention that FNMA's deductions should be disallowed because the CMS transactions lacked economic substance and reality. The court stated that genuine losses should not be disallowed simply because the petitioner is motivated by a desire to reduce its taxes. The Tax Court then cited what it found to be legitimate business reasons apart from

tax reduction that motivated FNMA to engage in the CMS transactions: (1) increasing its holdings of urban loans in compliance with HUD regulations; (2) expanding its customer base by developing relationships with savings and loan institutions; (3) increasing the number of mortgages with enforceable due-on-sale clauses; and (4) supporting the secondary mortgage market by helping struggling S&Ls.

On appeal, the Commissioner renews his argument that FNMA did not incur any recognizable losses in the CMS transactions. First, the Commissioner argues that because the mortgages exchanged were “substantially identical” under R-49, they cannot be “materially different” for tax loss recognition purposes. Second, the Commissioner contends that even if FNMA realized a loss, IRC § 165 precludes deduction of losses resulting from the CMS transactions because they lack economic substance.

2. Analysis

The Fifth Circuit and the Sixth Circuit recently reached contrary conclusions about whether parties realize—and thus may recognize—tax losses from a CMS transaction. See *San Antonio Savings Ass’n v. Commissioner*, 887 F.2d 577 (5th Cir. 1989) (“SASA”) (holding that CMS transactions may generate recognizable tax losses); *Centennial Savings Bank v. United States*, 887 F.2d 595 (5th Cir. 1989) (same); *First Federal Savings & Loan Ass’n v. United States*, 887 F.2d 593 (5th Cir. 1989) (same). But see *Cottage Savings Ass’n v. Commissioner*, 890 F.2d 848 (6th Cir. 1989) (finding no recognizable loss because the taxpayer’s “economic position” was not changed by the CMS transactions). We conclude that the Fifth Circuit’s decision in SASA provides the correct evaluation of the tax consequences of a CMS transaction and note that although SASA involved a three-party transfer, its holding

is equally applicable to the two-party CMS transactions in the case *sub judice*. See *Centennial*, 887 F.2d at 597.

a. Material Difference

1) *The Code and Regulations*. Treasury Regulation § 1001-1(a) provides the general rule that

[e]xcept as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Both parties recognize that the swap of mortgages occurring in a CMS transaction constitutes an exchange of property. The only question remaining is whether the mortgages that FNMA received differed materially from the mortgages that it exchanged.

In order for a loss resulting from an exchange of property to be recognized for tax purposes it must be realized, and in order for this loss to be realized, the property exchanged must be materially different. Although § 1001-1(a) does not create the “material difference” requirement for realization, it incorporates this requirement—which finds ample support in caselaw—by reference. See *SASA*, 887 F.2d at 581-87.

2) *Effect of R-49*. The Commissioner argues that the mortgages exchanged in the CMS transactions cannot have been “materially different,” because the exchanges were carried out pursuant to R-49, which required the mortgages exchanged to be “substantially identical.” The Commissioner contends that this court owes substantial deference to the FHLBB’s determination. This assertion is flawed for the reasons noted by the Fifth Circuit in *SASA*:

The FHLBB is not in the business of interpreting the Internal Revenue Code. So also the IRS is not sup-

posed to interpret the Federal Home Loan Bank Act. Here the IRS is arguing that deference should be shown in a tax determination case to a ruling by an agency which is not charged with enforcing the tax code. The FHLBB held that the mortgages in R-49 exchanges are "substantially identical" for its own accounting. The IRS would have us defer to the FHLBB on the "substantial identity" but not on the "material difference" of the loans, and it would apply the "substantial identity" ruling (an accounting ruling) to the tax standard of "material difference." "[I]t has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." *Bellefontaine Federal Sav. & Loan Ass'n v. Commissioner*, 33 T.C. 808, 811-812 (1960).

887 F.2d at 591; *see also Thor Power Tool v. Commissioner*, 439 U.S. 522, 544 (1979).

The Tax Court determined that the mortgages exchanged in the CMS transactions were "materially different" because the obligors were different, the property securing the loans was different, and the geographic distribution of the mortgaged property varied. Significantly, the Tax Court also found that the exchanged properties performed differently following the CMS transactions at issue. This confirmed the court's conclusion that the mortgages that FNMA received in the transactions were " 'really different from what he theretofore had.' " 90 T.C. at 423 (quoting *Weiss v. Stern*, 265 U.S. 242, 254 (1924)). The Commissioner does not dispute the trial court's factual findings.

We are persuaded that the differences in the mortgages exchanged are sufficient to support the Tax Court's holding that they were materially different. The differences in

the underlying properties and obligors foreclose any argument that the exchanged mortgages were identical.

b. Section 165

IRC § 165(a) provides that a taxpayer is allowed to deduct any losses that it sustained during the taxable year for which the taxpayer did not receive offsetting compensation from insurance or some other source. Treasury Regulation § 1.165-1(b) states that a loss is not deductible if it derives from a transaction that lacks economic substance.

The Commissioner contends that the CMS transactions lacked economic substance because the mortgages exchanged were not materially different and the alternative business purposes for the exchanges found by the Tax Court are trivial or illusory. Because we conclude that the mortgages exchanged were substantially different, we necessarily reject the Commissioner's first line of reasoning. Likewise, the Commissioner has failed to demonstrate that the Tax Court's factual findings regarding the alternative business purposes motivating FNMA to engage in the CMS transactions were clearly erroneous.

In any case, we agree with the *SASA* court's conclusion that the CMS transactions did not lack economic substance even if the sole motive for entering these transactions was to obtain beneficial tax treatment of its losses. The Code and Regulation sections cited by the Commissioner are aimed at transactions that taxpayers enter to *generate* losses that would otherwise not exist. By contrast, it is indisputable that FNMA and the lenders with which it exchanged mortgages had suffered genuine losses in their respective mortgage portfolios because of escalating interest rates. The CMS transactions did not *produce* the losses in question; these exchanges merely provided a means to recognize the losses without simultaneously threatening the existence of the FHLBB-regulated lenders.

Thus, IRC § 165 and Regulation § 1.165-1(b) do not apply in this context. *See SASA*, 887 F.2d at 592-93.

As noted, the decision of the Sixth Circuit in *Cottage Savings* is in direct conflict with those of the Fifth Circuit on this issue. We reject the Sixth Circuit's reasoning and result in favor of the more persuasive analysis of the Fifth Circuit and the Tax Court of the tax consequences attending CMS transactions.

B. Resale/Refinance Program

1. Background

The Tax Court described the economic circumstances confronting FNMA when it initiated the Resale/Refinance program:

From 1980 through 1982, petitioner's assets consisted largely of long-term, fixed-rate mortgage loans. Interest rates had increased since the mortgage loans were issued and the value of the mortgages had therefore declined significantly. Petitioner's debt during those years was relatively short-term compared to its assets. As interest rates rose, the interest petitioner paid on its debt increased more rapidly than the interest it received on its assets. By 1979, petitioner was paying a higher interest rate on its new borrowings than the average rate it received from its mortgages. By 1981, petitioner was paying more interest on the debt it used to carry its mortgages than it was earning from the mortgages and was losing money. The situation threatened petitioner's economic viability.

Federal Nat'l Mortgage Ass'n, 90 T.C. at 407 (footnotes omitted). The Tax Court noted, and the Commissioner does not dispute, that FNMA engaged in the Resale/Refinance program to reduce its losses and accomplish other business objectives. *Id.* at 417.

The Resale/Refinance program was accomplished by a series of agreements between three parties—FNMA, borrowers on mortgages held in FNMA's portfolio, and lenders who serviced those mortgages. Through the Resale/Refinance program, FNMA replaced old below market-rate mortgages in its portfolio with new mortgages secured by the same property. The new mortgages were greater in principal amount and carried a higher, but still below-market interest rate.

FNMA did not originate the new mortgages that it obtained under the Resale/Refinance program. Instead, the lender contacted a borrower on an FNMA-held loan who wanted to obtain more credit at a below-market rate. The lender then obtained a 90-day commitment from FNMA to buy the new mortgage from the lender at its face amount. FNMA's "obligation to purchase the new mortgage was contingent on the borrower's payment in full of the remaining principal amount of the original mortgage." *Id.* at 419. The mechanics of a Refinance transaction entailed: (1) the borrower's receipt of additional funds in return for the execution of the new mortgage, (2) retirement of the original loan, and (3) FNMA's purchase of the new loan at face amount from the lender. As described by the Tax Court:

At the settlement of a new mortgage, the borrower would execute the new mortgage, and the lender originating the new mortgage would transfer cash equal to the full principal amount of the new mortgage as follows: Cash equal to the unpaid principal balance of the original mortgage was paid by the lender to [FNMA], and the remainder of the cash was paid to the borrower.

After each settlement, the lender obtained the original mortgage note from [FNMA] and recorded the release of that lien with the local recorder of deeds. The

lender then submitted the new mortgage to [FNMA]. After [FNMA] confirmed that the original mortgage had been paid in full and that the terms of settlement were consistent with its commitment, it issued a check to the lender in the face amount of the new loan.

Id. at 419. A Resale transaction operated similarly to a Refinance transaction, except that in a Resale transaction, the borrower on each new mortgage was different than the obligor on the old mortgage.

FNMA reported neither gain nor loss from the Resale/Refinance transactions on its 1981 and 1982 federal income tax returns. Nor did FNMA report any gain or loss for financial accounting purposes. On its amended 1981 and 1982 returns, however, FNMA reported net losses of slightly over \$335 million from the Resale/Refinance program by treating the transactions as taxable exchanges of the old mortgages plus cash for the new mortgages. It measured the loss with respect to each new mortgage as the difference between the fair market value of the new loan and the sum of FNMA's basis in the original mortgage secured by the same property plus the cash payment made by FNMA to the lender.

The Commissioner disallowed the loss deduction in full. He treated each Resale/Refinance transaction as a payoff of an old loan by the borrower followed by FNMA's purchase of a new loan from the lender. Accordingly, the Commissioner determined that FNMA had realized gain of over \$28 million, the amount by which the unpaid balance of the old loans exceeded FNMA's bases in those loans.

The Tax Court upheld the Commissioner's determination. Although the Tax Court acknowledged that the Resale/Refinance transactions were interrelated, it reasoned that once the old mortgage had been paid off, the old note marked paid, and the lien securing it released, no property remained for FNMA to exchange for the new mortgage.

FNMA, invoking the "step-transaction" doctrine, asks this court to skip over the interim step of the old loan pay-offs and to focus solely on the starting and terminal points of the Resale/Refinance program for FNMA. At the outset, FNMA held an old below-market rate mortgage; after a Resale/Refinance transaction, FNMA held a new, still below-market rate mortgage in its stead. Under the step-transaction doctrine, one of the applications or manifestations of the substance-over-form doctrine, "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result . . . will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation." *Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954).

2. Analysis

The Tax Court provided two bases for disposing of FNMA's argument that each Resale/Refinance transaction must be viewed as a taxable exchange of the existing mortgage plus cash for the new higher-rate mortgage. First, the court found that FNMA had not shown an honest and consistent respect for what it claimed to be the substance of the Resale/Refinance transactions. The Tax Court seemed concerned that FNMA had engaged in procedural sleight of hand by recharacterizing these transactions *post hoc* in order to maximize its tax position. Second, the Tax Court determined that there had been no genuine "exchange" in each Resale/Refinance transaction, as the original mortgage was paid off before FNMA purchased the new mortgage from the lender.

We agree with the second reason for the Tax Court's holding on this issue. In order for FNMA to succeed in proving a recognizable loss, it must be able to show a genuine exchange; FNMA has failed to do so. We need not resolve the ephemeral question of "form versus substance"

implicit in the Tax Court's determination that FNMA did not show an "honest and consistent respect" for what it claims to be the "substance" of the Resale/Refinance transactions.

FNMA's undisputed goal in engaging in Resale/Refinance transactions was to improve its economic standing by eliminating mortgages in its portfolio that had become uneconomical to maintain. FNMA did replace these mortgages with new, higher-rate mortgages. The difficulty with FNMA's tax argument is that an "exchange" for tax purposes is a term of art with specific legal requirements and consequences. FNMA's attempt to broaden the definition of "taxable exchange" to include the sort of replacement that occurred in this case in unavailing.

The Commissioner correctly notes that Treasury Regulation § 1.1002-1(d) defines an exchange as "a reciprocal transfer of property." Tax cases describing exchanges echo this notion of reciprocity in the transfer of property rights, and support applying some version of the substance-over-form doctrine to characterize *reciprocal* purchases and sales as exchanges for tax purposes. See *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1980); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968); *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967); *Allegheny County Auto Mart, Inc. v. Commissioner*, 12 T.C.M. (CCH) 427, *aff'd per curiam*, 208 F.2d 693 (3d Cir. 1953); Rev. Rul. 77-297, 1977-2 C.B. 304.

In *Carlton*, the Fifth Circuit recognized that a court must look beyond the form of a transaction "to determine its reality and substance, for it is the substance of the transaction which decided the incidents of taxation." 385 F.2d at 242. Even applying this holistic approach to evaluating a transaction, however, the court made clear that it could not find an "exchange" in substance absent a genuine "transfer of property *between* owners." *Id.* (emphasis supplied).

Revisiting the “exchange” issue in *Biggs*, the Fifth Circuit disavowed the argument that *Carlton* “establishes as an absolute prerequisite to a § 1031 exchange that the purchaser have title to the exchange property.” *Biggs*, 632 F.2d at 1176. The court recognized that such a holding would conflict with the circuit’s decision in *W.D. Haden Co. v. Commissioner*, 165 F.2d 588 (5th Cir. 1948), in which the court held that it was possible to effect an “exchange” for tax purposes where one party had bound “‘himself to exchange property he did not own but could acquire.’” *Biggs*, 632 F.2d at 1177 (quoting *Haden*, 165 F.2d at 590). Thus, even in *Haden*, the case bearing the greatest factual similarity to the case *sub judice*, the court finding an “exchange” required that the parties to the transaction have at least a contractual interest in the property transferred.

FNMA asserts that in each Resale/Refinancing transaction it “exchanged” an old FNMA-owned mortgage (plus “boot”) for a new lender-owned mortgage. Yet, FNMA fails to demonstrate where a reciprocal transfer with the lender occurred. The lender never acquired ownership of the old mortgage; FNMA remained as the mortgagee until the old mortgage was discharged. Neither did the lender—under a *Haden*-type approach—acquire a contractual right to purchase the old mortgage before its discharge. At the time that FNMA purchased the new mortgage from the lender, there was nothing left to exchange. One might hypothesize various ways that FNMA *could* have effected a genuine “exchange” of mortgages, but, given the way FNMA structured these transactions, there was no “exchange” in form or substance.

FNMA essentially urges this court to find that FNMA is entitled to the loss it claims because it *could* have structured the Resale/Refinance transactions as exchanges. Allowing FNMA to recast the form of the transaction that it

actually undertook in order to achieve some more favorable tax consequence, however, would contravene the Supreme Court's teaching on this issue:

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *Higgins v. Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, 293 (1934); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders General Corp. v. Hoey*, 300 U.S. 268, 275 (1937); *Television Industries, Inc. v. Commissioner*, 284 F.2d 322, 325 (2d Cir. 1960); *Interlochen Co. v. Commissioner*, 232 F.2d 873, 877 (4th Cir. 1956). See *Gray v. Powell*, 314 U.S. 402, 414 (1941).

Commissioner v. National Alfalfa Dehydrating and Milling Co., 417 U.S. 134, 149 (1974). Cases adopting this approach emphasize the need for certainty and convenient administration in the tax system:

It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax law shall be that resulting from the form of the transaction taxpayers have chosen or from any other form they might have chosen, whichever is less.

Television Industries, 284 F.2d at 325.

We are unwilling to depart from this prudent course. FNMA failed to structure its deal to effect a genuine exchange of mortgages; it must live with the tax consequences of the transaction it freely chose to undertake.

3. Calculation of Liability

FNMA urges that, even if the Resale/Refinance transactions were not taxable exchanges, the Commissioner erred in computing FNMA's tax liability. The Commissioner calculated FNMA's liability by subtracting FNMA's basis in each mortgage from the amount FNMA received to discharge that mortgage (in each case, the unpaid principal balance of the mortgage). FNMA contends that the amount it received to pay off each mortgage must be allocated between two assets: (1) the original mortgage, and (2) FNMA's contractual commitment to purchase the new mortgage. FNMA reaches this result because it asserts that upon receipt of the cash payment, FNMA gave up more than the old mortgage: it also gave the lender the contractual right to sell a specified new mortgage to FNMA at face value, i.e., for an amount in excess of its fair market value. Under this approach, FNMA concludes that the amount it received to discharge the mortgage must be allocated in proportion to the fair market value of the old and new mortgages.

We reject this approach. This argument erroneously assumes that the *lender's* funds were used to discharge the original mortgage and to secure FNMA's contractual obligation to purchase the new loan. As noted, however, the funds that the lender transferred to FNMA to discharge the original mortgage belonged to the *borrower*. It is implausible, therefore, that some of these funds were used to secure a contractual right for the lender's benefit. This seems especially true because, under this approach, the borrower would realize discharge-of-indebtedness income to the extent that the original mortgage was discharged for less than its face value. Even apart from these inconsistencies, all of the documents surrounding the Resale/Refinance transactions show that the original mortgages were paid in full, rendering FNMA's tortured construction even less credible.

4. Amendment of Commissioner's Answer

FNMA argues that the Commissioner admitted in his Answer that the Resale/Refinance transactions were exchanges, and that the Tax Court erred in allowing the Commissioner to amend his Answer to strike this admission. The decision whether to grant or deny leave to amend is within the sound discretion of the trial court and may be reversed only if it is a clear abuse of discretion. See *Foman v. Davis*, 371 U.S. 178, 182 (1962); *Williamsburg Wax Museum, Inc. v. Historic Figures, Inc.*, 810 F.2d 243, 247 (D.C. Cir. 1987). Because of the deference that we must accord a trial judge's decision whether to allow amendments of the pleadings, we do not disturb the Tax Court's determination.

First, FNMA did not raise the issue of the Commissioner's admission until it filed its post-trial brief. The trial was conducted under the assumption that the Commissioner contested FNMA's claim that the Resale/Refinance transactions constituted taxable exchanges. Therefore, FNMA cannot reasonably claim that it was somehow unaware of the Commissioner's position and was deprived of an opportunity to rebut adequately the Commissioner's arguments. Because this is the underlying purpose of the pleading requirements, we do not see how FNMA was legitimately prejudiced by the Tax Court's decision to allow the Commissioner to amend. FNMA's delay until after the trial to raise the "admission" issue also deflates FNMA's contention that the Commissioner waited too long to request leave to amend.

Significantly, FNMA has not argued that it has any additional evidence by which it would amplify or clarify the trial record in light of the withdrawal of the Commissioner's admission. Given the obvious positions of the parties in the Tax Court proceeding, it would be disingenuous for FNMA now to claim that it relied to its detriment on the

Commissioner's admission in preparing and arguing its case at trial.

Second, we reject FNMA's argument that the Commissioner's admission was clearly consistent with the position the Commissioner had taken during the administrative proceedings in this case. Language in the report generated by the IRS appeals officer assigned to this case indicates that this officer viewed "the payoff of the old mortgage and purchase of the new mortgage [as] a single, unified transaction." This does not indicate, however, that this officer viewed the transaction as an exchange for tax purposes. FNMA's assertion that this language "squarely rebut[s]" the Commissioner's assertion that the "admission" was an oversight is at least hyperbolic.

The Tax Court's decision to allow the Commissioner to amend his Answer is far from the kind of clear abuse of discretion that would warrant reversal.

III

The economic turmoil confronting FNMA at the time it engaged in these disputed transactions was great. The urgency of the problems apparently precluded a thorough consideration of the tax consequences of the remedial actions FNMA undertook. FNMA, as a result, joins a long list of taxpayers who did their tax planning too late to obtain the benefits that such planning might otherwise have provided. A decent regard for the Commissioner's difficulties in administering a complex tax code precludes us from "rearranging" the transactions in order to downsize FNMA's taxes on the Resale/Refinance transactions.

We affirm the Tax Court's resolution of both issues raised on appeal. Because the mortgages swapped in the CMS transactions were "materially different," FNMA is entitled to recognize the losses it incurred. In order to recognize losses in the Resale/Refinance transactions, how-

ever, FNMA had to demonstrate a genuine exchange of mortgages. Because FNMA has not shown such an exchange, it cannot recognize the losses it claims from these transactions.

APPENDIX B

UNITED STATES TAX COURT

Docket No. 21556-86

FEDERAL NATIONAL MORTGAGE ASSOCIATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

[Filed Mar. 14, 1988]

P exchanged interests in pools of mortgage loans it owned for interests in pools of mortgage loans owned by unrelated third parties. *Held*, P realized recognizable losses on the exchanges. Secs. 165, 1001, I.R.C.

P purchased mortgage loans that had been made by unrelated lenders. The proceeds of the mortgage loans were used, in part, to repay other mortgage loans that P owned. *Held*, P did not exchange the mortgage loans that had been repaid for the mortgage loans it purchased. *Held further*, P realized taxable gain when its bases in the mortgage loans that were repaid were less than the amounts that were repaid.

Felix B. Laughlin, Joseph Angland, and Michael Schlesinger, for the petitioner.¹

¹ Brief amicus curiae was filed by Richard L. Bacon as attorney for the United States League of Savings Institutions.

Kendall C. Jones and Lawrence M. Hill, for the respondent.

KÖRNER, *Judge*: Respondent determined deficiencies in petitioner's Federal corporate income tax as follows:

<i>Year</i>	<i>Deficiency</i>
1971	\$ 147,902
1973	9,558,360
1977	3,764,520
1979	10,948,154

In addition to contesting these determinations, petitioner has requested that this Court find overpayments as follows:

<i>Year</i>	<i>Overpayment</i>
1977	\$93,185,818
1979	46,631,003

After concessions, the issues for decision are: (1) Whether petitioner realized recognizable losses in 1980 and 1981 when it exchanged interests in pools of mortgage loans, and (2) whether petitioner realized recognizable gains or losses in 1981 and 1982 when it received payment on old mortgage loans and purchased new mortgage loans in connection with its Resale/Refinance Program.²

² Claimed losses from 1980, 1981, and 1982 were carried back to the years at issue. Respondent's disallowance of the losses at issue contributed to the deficiencies determined. Although we have no jurisdiction over petitioner's tax liabilities for the years 1980, 1981 and 1982 in this case, we may consider events occurring in those years as they may affect tax liability of petitioner in the years before us. Sec. 6214(b), I.R.C. of 1954.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

BACKGROUND

Federal National Mortgage Association ("petitioner"), is a corporation whose principal place of business was in Washington, D.C., when it filed its petition herein. Petitioner filed its Federal corporate income tax returns for the years at issue on a calendar year basis and used an accrual method of accounting.

Petitioner was originally established in 1938 as an agency of the Federal Government. In 1968, it was transformed into a for-profit, privately owned, corporation. Although it is now privately owned, it retains close ties with the Federal Government. During 1980, 1981, and 1982, the President of the United States appointed one-third of petitioner's directors. Additionally, petitioner remains subject to regulation by the Secretary of the Department of Housing and Urban Development ("HUD").

Petitioner has a Congressional mandate to "provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." Housing Act of 1954, ch. 649, tit. II, sec. 202, 68 Stat. 612, 12 U.S.C. sec. 1716(a) (1982). Petitioner provides liquidity for mortgage investments primarily by purchasing mortgages from lenders, using funds it acquires by issuing stock and debt securities. Its mortgage purchases have made petitioner the largest investor in home mort-

gages in the United States.³ Petitioner's net mortgage portfolio balance at December 31 for the years 1979 through 1982 was as follows:

<i>Year</i>	<i>Balance</i>
1979	\$49.7 billion
1980	55.7 billion
1981	59.8 billion
1982	69.7 billion

From 1980 through 1982, petitioner's assets consisted largely of long-term, fixed-rate mortgage loans. Interest rates had increased since the mortgage loans were issued and the value of the mortgages had therefore declined significantly.⁴ Petitioner's debt during those years was relatively short-term compared to its assets. As interest rates rose, the interest petitioner paid on its debt increased more rapidly than the interest it received on its assets. By 1979 petitioner was paying a higher interest rate on its new borrowings than the average rate it received from its mortgages.⁵ By 1981 petitioner was paying more interest on the debt it used to carry its mortgages than it was earning from the mortgages and was losing money.⁶ The situation threat-

³ In some parts of the United States, home financing is typically done through mortgages; in other areas, deeds of trust are used. In the context of the present case, it is a distinction without a difference. For convenience, the promissory notes in which petitioner invested, secured by liens on real property, will be referred to as mortgages.

⁴ On December 31, 1980, the total fair market value of the mortgages held by petitioner was only 69.75 percent of their face value.

⁵ Petitioner paid an average interest rate of 10.72 percent on amounts it borrowed during 1979. The average yield from its mortgages was only 8.75 percent on December 31 of that year.

⁶ In 1981, petitioner's interest expense on debt incurred to carry mortgages exceeded its interest income from its mortgage loans by \$260,000,000.

ened petitioner's economic viability. In an effort to remedy the financial difficulties in which it found itself, petitioner entered into two types of transactions that produced the claimed losses now in issue: Concurrent Mortgage Sales and the Resale Refinance Program.

I. Concurrent Mortgage Sales

In 1980 and 1981 petitioner engaged in 71 transactions, referred to as Concurrent Mortgage Sales ("CMS") transactions, with 50 unrelated financial institutions, including 40 savings and loan associations, five commercial banks, two savings banks, and three mortgage bankers. In each CMS transaction, the parties exchanged 90-percent undivided participation interests in two groups of home mortgage loans.⁷ Petitioner claimed the following tax losses from the CMS transactions:

<i>Year</i>	<i>Loss</i>
1980	\$194,573,659
1981	70,042,179

Petitioner began considering CMS transactions in early 1980 when its tax counsel advised Robert J. Mahn, petitioner's controller, that petitioner could recognize the losses that it had suffered due to the decrease in value of

⁷ The transactions were sales in form as the parties exchanged payments for the participation interests they obtained. It is customary in the secondary market for parties to sell participation interests in mortgage loans. That technique reduces the administrative expenses that would result from the transfer of the ownership of the entire loan. For convenience, rather than stating that the parties to the CMS transactions exchanged "participation interests in home mortgage loans," the remainder of this discussion will state that the parties exchanged "mortgages."

its mortgage loan portfolio by engaging in the transactions. Mahn thereafter gave considerable thought to whether CMS transactions would be desirable for petitioner.

When Mahn analyzed the desirability of CMS transactions, the first benefit that he considered was the tax benefit. Mahn realized that the loss carryback and carryforward provisions of the Code might enable petitioner to recover Federal income taxes it had paid in earlier years and avoid paying some taxes in future years. As Mahn analyzed the proposed CMS transactions, it became apparent to him that they would also yield petitioner several significant nontax benefits, which are discussed more fully *infra*.

After he thoroughly evaluated the proposed CMS program, Mahn recommended that petitioner sponsor the program and engage in the transactions. Petitioner's Board of Directors approved the proposed program in June 1980.

A. Selection Criteria

Although petitioner was not subject to regulation by the Federal Home Loan Bank Board ("FHLBB"), most of the financial institutions with which it engaged in CMS transactions were. The savings and loan associations that participated in the CMS transactions were required to file semi-annual financial reports with the FHLBB reporting their financial condition in conformity with accounting principles adopted by the FHLBB; those principles are commonly referred to as regulatory accounting principles ("RAP"). FHLBB rules provided that federally insured savings and loan associations whose net worth, as measured according to RAP, fell below certain standards could be closed by the FHLBB.

In 1980 and 1981, savings and loan associations generally were in very weak financial condition. An unprece-

dented surge in interest rates had left savings and loan associations with stagnant interest revenues from their low-interest mortgage loans and escalating interest costs for attracting depositors' funds to support the mortgage loans. As a result of this squeeze on interest margins, the savings and loan industry's net income plummeted from an historical high of \$3,918 million in 1978 to a loss of \$4,632 million in 1981. The annual rates of return on assets of insured savings and loan associations for the years 1978 through 1981, which illustrate the drastic downturn in 1980 and 1981, are set forth below:

*Return on Assets of
Insured Savings Associations*

1978	0.84%
1979	0.68%
1980	0.13%
1981	-0.93%

The savings and loan industry was widely perceived to be in imminent danger of collapse.

Savings and loan associations and other financial institutions had an economic incentive to recognize for tax purposes the losses that they had suffered due to the decrease in value of their mortgage loan portfolios. There would have been risk in doing so, however, had they been compelled to recognize the losses for purposes of reporting to the FHLBB, thereby decreasing their net worth and risking closure by the FHLBB.

On June 27, 1980, the FHLBB issued Memorandum R-49 in which it set forth 10 criteria that the mortgages exchanged were required to meet in order for no loss to be

recognized from the CMS transactions under RAP. Specifically, the mortgages all had to:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),⁸
3. have the same stated term to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½ % or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

In order to ensure that the mortgages it received in these transactions satisfied minimum quality standards, petitioner imposed four additional criteria that mortgages were required to meet to be involved in CMS transactions:

1. All loans must have been in a current or prepaid status.
2. Any loan that had been 30-days delinquent more than once in the prior 12 months was excluded from consideration.

⁸ In this context, a "conventional" mortgage is a mortgage that is neither insured by the FHA nor guaranteed by the VA. FHA-insured loans are insured by the Federal Housing Administration against loss in the event of a default by the borrower. VA-guaranteed loans are guaranteed by the Veterans Administration against loss due to default.

3. All loans must have been originated at least 12 months prior to the transaction.

4. In the case of FHA loans, graduated payment mortgages were excluded.

In addition, any loan whose current unpaid principal balance exceeded petitioner's loan ceiling was excluded from eligibility.

The mortgages underlying the 90-percent participation interests that were exchanged in each CMS transaction were chosen so as to comply with the above criteria.⁹

B. Implementing the CMS Transactions

Any financial institution that wished to participate in the CMS program submitted to petitioner a computer tape containing information about the mortgages that it was making available for possible inclusion in the exchange.

In each transaction, petitioner's computer sorted the mortgages on the tape into categories defined by the criteria in Memorandum R-49. That is, all the mortgages in a particular category would have the same interest rate, have underlying properties in the same state, be of the same type (i.e., conventional, FHA or VA), and have similar remaining terms and (for conventional mortgages) original loan-to-value ratios. Petitioner's computer then sorted the mortgages from petitioner's portfolio into the same categories. Within each category, the computer then selected a pool of mortgages from each portfolio for inclu-

⁹ For example, conventional 30-year mortgage loans, secured by properties in Virginia, that paid 8-percent interest, had a remaining life of between 17 and 18 years, and had a loan-to-original-value ratio of between 80.01 and 90 percent would be exchanged only for loans that satisfied those same criteria.

sion in the transactions. As Memorandum R-49 required that the aggregate principal balances of each pool of petitioner's mortgages and each corresponding pool of the other institution's mortgages be within the lesser of \$100,000 or 2.5 percent of one another, not every mortgage in every category was included in the pools that were exchanged. For each category, the computer dropped mortgages from one or both sides until the principal balances of the remaining mortgages became approximately equal. When selecting mortgages for petitioner to receive, petitioner's computer gave preference to loans whose underlying properties had urban postal zip codes; when selecting mortgages to exchange, petitioner's computer gave preference to loans whose underlying properties did not have urban zip codes.

C. Determination of Petitioner's Tax Loss

Each package of mortgages included in a CMS transaction was valued at a price reflecting its fair market value, and each party transferred funds to the other, representing the fair market value of the mortgages acquired. The two transfers were as close as possible, but not precisely identical in amount. Petitioner computed its tax loss on each transaction by calculating the difference between 90 percent of its total tax basis in the underlying mortgages and the value of the package it received.¹⁰

Although petitioner required the mortgages it received to meet certain minimum standards, it did not take any steps to ensure that such mortgages were likely to have the

¹⁰ Petitioner's tax basis in each mortgage was its cost basis in the loan, plus the amortized discount and less the amortized principal relating to the mortgage, all as of the sale date.

same payment characteristics, delinquency rates, and foreclosure rates as the mortgages it exchanged.¹¹ In fact, petitioner recognized that there were a number of significant differences between the mortgages that made it unlikely that they would behave the same economically. Specifically, in each CMS transaction: (1) the mortgages that petitioner received had different obligors than the mortgages it exchanged; (2) the real properties securing the mortgages that petitioner received were different from the real properties securing the mortgages that petitioner exchanged; and (3) the geographic distribution of the real properties securing the mortgages varied. Petitioner accepted the risk that the mortgages would behave differently economically in order to receive the benefits that it derived from the transactions.

Since the CMS transactions took place, the mortgages that petitioner received in fact have performed differently than the mortgages that petitioner exchanged. In each CMS transaction, the mortgage pool that petitioner received exhibited different delinquency ratios from the mortgage pool that petitioner exchanged. For most CMS transactions, there were differences in the number and timing of foreclosures between the mortgages that petitioner received and exchanged. For most CMS transactions, there were differences in the number of mortgages that were prepaid in full between the mortgages that petitioner received and exchanged. The overall percentages of the mortgages received and exchanged by petitioner that

¹¹ Petitioner did not underwrite any of the mortgages that it sold or exchanged in the CMS transactions.

were paid off and foreclosed through March 31, 1987 are as follows:

<i>1980 Transactions</i>	<i>Percent Foreclosed</i>	<i>Percent Paid Off</i>
Mortgages Received	0.65%	33.7%
Mortgages Exchanged	0.49%	29.7%
<i>1981 Transactions</i>		
Mortgages Received	0.27%	21.8%
Mortgages Exchanged	0.72%	23.9%

The following percentages of the mortgages received and exchanged by petitioner were delinquent as of the months indicated:

<i>1980 Transactions</i>		
<i>Month</i>	<i>Mortgages Received</i>	<i>Mortgages Exchanged</i>
Dec 1982	3.40%	2.67%
Dec 1983	3.84%	3.04%
Dec 1984	4.40%	2.88%
Mar 1985	4.10%	2.86%
Jun 1985	4.13%	2.52%
Sep 1985	3.92%	2.70%
Dec 1985	4.06%	2.89%
Mar 1986	4.73%	2.82%
Jun 1986	4.33%	2.77%
Sep 1986	4.13%	3.38%
Dec 1986	4.86%	4.31%
Mar 1987	4.08%	2.82%

1981 Transactions

<i>Month</i>	<i>Mortgages Received</i>	<i>Mortgages Exchanged</i>
Dec 1982	4.96%	2.14%
Dec 1983	3.91%	2.67%
Dec 1984	3.88%	2.82%
Mar 1985	5.07%	2.69%
Jun 1985	4.59%	2.49%
Sep 1985	3.86%	2.65%
Dec 1985	4.88%	3.16%
Mar 1986	4.21%	3.23%
Jun 1986	5.11%	2.55%
Sep 1986	3.61%	3.34%
Dec 1986	4.54%	2.70%
Mar 1987	3.42%	3.98%

D. Petitioner's Motives for the Transactions

Petitioner conducted CMS transactions for a number of reasons in addition to recognizing losses for tax purposes. Those reasons included: increasing its holdings of urban loans; expanding its customer base by developing relationships with savings and loan associations; increasing the portion of its portfolio with enforceable due-on-sale clauses; and bolstering the secondary mortgage market by helping ailing savings and loan associations to diversify their portfolios and to recognize losses for tax purposes.

1. Increase in Urban Loan Holdings—Petitioner engaged in the CMS transactions, in part, to increase its holdings of urban loans. In the late 1970's, petitioner came under substantial pressure from the Secretary of HUD, its principal regulator, to increase its holdings of urban mortgage loans. The Secretary of HUD was so dissatisfied with peti-

tioner's efforts that she attempted to have the chairman of petitioner's board removed. HUD also promulgated regulations to mandate that 30 percent of petitioner's annual mortgage purchases be urban mortgages.¹² On June 17, 1980, in its resolution approving the CMS program, petitioner's Board of Directors listed serving the needs of the urban and low/moderate income sectors of the mortgage market as one of the purposes of the CMS transactions.

The system petitioner developed for selecting mortgages for the CMS transactions gave priority to urban mortgages in the packages to be received by petitioner and to nonurban mortgages in the packages to be exchanged by petitioner. As each CMS transaction was consummated, petitioner recorded the number of urban mortgages received and exchanged, along with the associated unpaid principal balance. As a result of the CMS transactions, petitioner acquired urban mortgages with an unpaid principal balance of about \$318 million, while giving up urban mortgages with an unpaid principal balance of about \$121 million. Petitioner thus increased its interests in urban mortgages by approximately \$197 million.

2. Expansion of Customer Base—Petitioner engaged in the CMS transactions, in part, to broaden its customer base by establishing relationships with savings and loan associations. As of 1980, petitioner did the vast majority of its business with mortgage bankers and very little with savings and loan associations. Petitioner wanted to increase its business with savings and loan associations. Petitioner hoped to use the CMS transactions to establish initial con-

¹² In 1978 HUD promulgated final regulations that require at least 30 percent of the mortgages petitioner purchases each calendar year to be secured by urban properties in order to prevent HUD from establishing a mandatory annual goal for urban purchases. See 24 C.F.R. § 81.16(d)(1) (1987); 43 Fed. Reg. 36,200 (Aug. 15, 1978).

tacts with particular savings and loan associations that would lead to additional business with them. Petitioner was only modestly successful in achieving this goal: Of the 48 still-existing institutions that participated with petitioner in a CMS transaction during 1980 and 1981, 37 had never dealt with petitioner before. Subsequent to the transactions, 14 of these new customers continued doing business with petitioner in transactions outside the CMS program.

3. **Due-on-Sale Enforcement**—Before November 10, 1980, petitioner had a policy of not enforcing due-on-sale clauses in most mortgages it held.¹³ Petitioner had directed the lenders that serviced the loans it owned to advise the borrowers of the policy.

Petitioner's nonenforcement policy meant that a borrower who was paying a below-market interest rate could sell his home and allow the buyer to assume the existing mortgage at the below-market interest rate. As a result of its nonenforcement policy, petitioner was frequently left holding low-yielding mortgages at times when its cost of borrowing funds had increased. Consequently, decreasing its holdings of assumable mortgages was one of petitioner's objectives as of 1980. Petitioner had not yet changed its policy regarding due-on-sale clause enforcement when the CMS program was approved in June 1980, but it was already seriously considering changing its policy.

¹³ "Due-on-sale" clauses permit the holder of a mortgage to require full repayment of such loan if the mortgagor sells the underlying property. As of 1980, the due-on-sale clause was a common feature in conventional mortgage instruments. Prior to 1972, conventional mortgages frequently contained no "due-on-sale" clause, and were freely assumable, or properties were taken "subject to" existing mortgages by the purchaser.

In August of 1980, petitioner announced a prospective change in its policy, and it began enforcing due-on-sale clauses in all conventional mortgages purchased pursuant to commitments issued on or after November 10, 1980. For the mortgages already in its portfolio, petitioner honored its promise of not enforcing the due-on-sale clauses. Petitioner adopted this policy change in order to improve the yield on its mortgage portfolio.

The CMS transactions gave petitioner the opportunity to replace mortgages with due-on-sale clauses that it had promised not to enforce with mortgages containing due-on-sale clauses that it was free to enforce under its new policy. It offered petitioner some measure of future protection against the predicament in which petitioner then found itself—holding long-term lower fixed-rate mortgages in a rapidly rising interest market.

4. Bolstering the Secondary Market—One of the reasons that petitioner entered into the CMS transactions was to bolster the savings and loan industry. As a result of its Congressional mandate to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, petitioner felt a general obligation to enhance the financial viability of the savings and loan industry. Petitioner viewed the CMS transactions as being potentially beneficial to savings and loans for two reasons: First, the program gave savings and loan associations with mortgage loan portfolios that were geographically concentrated within a state the opportunity to diversify the geographic distribution of their portfolios and thus make themselves less vulnerable to localized economic downturns. Second, the program gave savings and loans the opportunity to obtain Federal income tax refunds by recognizing the losses that they had suffered due to the decline in the value of their mortgage portfolios.

E. Conclusion of the CMS Program

Petitioner completed its last CMS transaction in June 1981. The transaction ended then because savings and loans stopped approaching petitioner about engaging in CMS transactions.

Petitioner reported losses from its 1980 CMS transactions on its original Federal corporate income tax return for 1980. Respondent disallowed the deduction of the loss. Petitioner paid the resulting deficiency and subsequently filed an amended return for 1980 to reclaim the deduction. Petitioner did not report losses from its 1981 CMS transactions on its original return for 1981. It instead claimed the loss on an amended return for 1981. Respondent disallowed the deduction of the losses claimed on the amended returns.

Petitioner did not report losses from the CMS transactions for financial accounting purposes.

II. Resale/Refinance Transactions

As another means of alleviating the financial problem which petitioner faced in 1980 and 1981 — holding a large portfolio of fixed rate, low interest, long-term loans at a time of rapidly escalating market interest rates — petitioner instituted the Resale/Refinance Program (the “Program”) in March of 1981.¹⁴ The Program was designed by petitioner to accomplish a number of business objectives. Specifically, the Program was designed to: (1) enable petitioner to replace below-market-rate mortgages held in its portfolio (“original mortgages”) with new higher-rate, but

¹⁴ In a “Resale” transaction, the new mortgage acquired by petitioner was originated to finance the resale of the property that had secured the old mortgage; in a “Refinance” transaction, the new mortgage acquired by petitioner was originated to refinance the old mortgage and to extend additional cash to the borrower.

still below-market, mortgages secured by the same property; (2) reduce the number of mortgages in petitioner's portfolio that had due-on-sale clauses that petitioner had agreed not to enforce; (3) reduce the number of mortgage loans in petitioner's portfolio that, by their terms, were freely assumable; and (4) discourage the practice of "wrapping around" the original mortgages.¹⁵

The principal amount of each new mortgage was greater than the unpaid principal balance of the original mortgage by the amount of the additional cash loaned. The term-to-maturity of each new mortgage was 30 years and always exceeded the remaining term-to-maturity of the original mortgage. Each new mortgage was assumable by a subsequent purchaser only within one year of when it was made, except if the property was located in a state that restricted due-on-sale enforcement. In contrast, each original mortgage was assumable anytime. Each new mortgage was a conventional mortgage, whereas the original mortgages could be FHA, VA, or conventional. For Resale/Refinance transactions in 1981 and 1982, 55 and 51 percent, respectively, involved original loans that were either FHA or VA. In Resale transactions, the borrower on each new mortgage was different than the obligor on the original mortgage. The stated interest rates of all of the original mortgages were fixed rates. The stated interest rates on the new mortgages were allowed to be either fixed rate or adjustable rate.

¹⁵ A wraparound mortgage loan is a special type of second mortgage loan. When a mortgage is "wrapped around," the new lender makes a second mortgage loan to a borrower with an existing first mortgage. The new lender then collects from the borrower the total due on the first and second mortgages, and pays the original lender the amount due on the first mortgage. The original lender is frequently either unaware that the first mortgage has been "wrapped," or has no right to prevent it.

Petitioner did not originate the new mortgages that it purchased under the Program. Petitioner instead directed the Program to the lenders who serviced the old mortgages in its portfolio. Lenders were willing to participate in the Program because it benefited them financially. The Program offered them the opportunity to receive fees for making the new loans, and to increase their servicing fee income.¹⁶ Additionally, the lenders shared in any interest that they could charge the borrowers on the new loans in excess of the required minimum yield set by petitioner. The lenders made the new mortgage loans and then sold them to petitioner, pursuant to petitioner's commitment to purchase such new loans which met its specifications. The new mortgages were obligations of third-party borrowers, and not of the lenders.

A lender would typically initiate a Resale/Refinance transaction by reviewing the portfolio of loans it was servicing for others to identify which mortgage loans were owned by petitioner. It would then contact the borrowers and attempt to convince them to acquire new loans. The incentive offered potential borrowers to refinance their original loans was that the Program enabled them to borrow a larger sum of money at a below-market rate.

When a lender located a borrower who was interested in participating in a Resale/Refinance transaction, the lender would obtain from petitioner a quotation of the interest rate that petitioner would require on the new mortgage loan. The *required* interest rate was a function of the prevailing market interest rate, the interest rate on the old

¹⁶ Servicing fees increased as the amount of the mortgage increased. Petitioner permitted lenders to charge loan origination fees of up to three points, out of pocket expenses, FNMA commitment fee, FNMA prior approval fee, and any loan discount charges that the seller must pay to FNMA because the loan yield was less than required by the commitment.

loan, the amount of the additional cash to be loaned, and the remaining balance and remaining term of the old loan. The interest rates *actually charged* on the new mortgages were not direct functions of those factors, however, as lenders had an incentive to charge higher rates. Petitioner's pricing formula was designed to arrive at a required interest rate on each new mortgage that was less than the prevailing market interest rate but higher than the interest rate on the old mortgage.¹⁷

If a borrower advised a lender that he wished to proceed with a Resale/Refinance transaction, the lender would obtain a 90-day commitment from petitioner to buy the new mortgage at its face amount. Petitioner's obligation to purchase the new mortgage was contingent on the payment in full of the remaining principal amount of the original mortgage.

At the settlement of a new mortgage loan, the borrower would execute the new mortgage, and the lender originating the new mortgage would transfer cash equal to the full principal amount of the new mortgage as follows: Cash equal to the unpaid principal balance of the original mortgage was paid by the lender to petitioner, and the remainder of the cash was paid to the borrower.

After each settlement, the lender obtained the original mortgage note from petitioner and recorded the release of that lien with the local recorder of deeds. The lender then

¹⁷ In 1981, the average interest rate on Resale/Refinance new loans was about 13.08 percent, the average interest rate on the old loans being replaced was about 9.15 percent, and the average market interest rate on newly issued 30-year fixed-rate conventional loans was about 16.39 percent. In 1982, the average interest rate on Resale/Refinance new loans was about 13.09 percent, the average interest rate on the old loans being replaced was about 9.28 percent, and the average market interest rate on newly issued 30-year fixed-rate conventional loans was about 15.30 percent.

submitted the new mortgage to petitioner. After petitioner confirmed that the original mortgage had been paid in full and that the terms of settlement were consistent with its commitment, it issued a check to the lender in the face amount of the new loan.

In 1981 and 1982, the Program resulted in petitioner's purchasing 35,885 new mortgage loans with a total face amount of \$2.116 billion, and the payment in full of original mortgage loans with a total unpaid principal balance of \$1.196 billion. Of the new mortgages purchased by petitioner, 22,269 mortgages with a total face amount of \$1.301 billion were purchased in Resale transactions and 13,616 mortgages with a total face amount of \$815 million were purchased in Refinance transactions.

A number of the original mortgages that were paid in full as a result of the Program were carried on petitioner's books at a discount from face value. For *tax* accounting purposes, petitioner normally amortizes discount arising from the purchase of a mortgage into income over the term of the loan. If a mortgage is prepaid in full, petitioner normally recognizes any unamortized discount as income in the year the loan is prepaid. Petitioner did not recognize the unamortized discount remaining on the original mortgages involved in the Program as income on its original Federal corporate income tax returns for 1981 and 1982. For tax accounting purposes, petitioner instead assigned the entire original discount from the old mortgages, including the portion of the discount that had been amortized previously into income, to the new mortgages and deducted any discount that had been amortized into income previously.¹⁸ Petitioner did not, however, report any tax

¹⁸ For example, if the original discount arising at the time the original mortgage was acquired by petitioner equaled \$10,000 and petitioner had subsequently amortized \$300 into income prior to refinancing the original mortgage, then in the year in which the new mortgage was acquired petitioner would claim a deduction of \$300 and assign \$10,000 of discount to the new mortgage.

consequences as the result of the 1981 and 1982 Resale/Refinance transactions on its original Federal corporate income tax returns for 1981 and 1982, except the deduction it claimed for the portion of the original discount from the old mortgages that had been amortized into income previously.

For *financial* accounting purposes, petitioner amortizes purchase discount into income over a 20-year period, regardless of prepayments or foreclosures. Petitioner accordingly reported neither gain nor loss from the Resale/Refinance transactions for financial accounting purposes.

On its amended Federal income tax returns for 1981 and 1982, filed on March 27, 1984, petitioner treated the payment in full of the old mortgages and its purchase of the new mortgages as taxable exchanges of the old mortgages plus cash for the new mortgages, resulting in the recognition of gain or loss on the disposition of the old mortgages.¹⁹ Petitioner accordingly reported on its amended returns for 1981 and 1982 that it realized the following net losses from Resale/Refinance transactions engaged in during those years:

<i>Year</i>	<i>Loss</i>
1981	\$211,337,943 ²⁰
1982	124,083,886 ²¹

¹⁹ On its amended Federal income tax returns for 1981 and 1982 petitioner measured its gain or loss with respect to each new mortgage as the difference between (i) the fair market value (as determined by petitioner at the time of receipt) of such new loan and (ii) the sum of petitioner's basis in the original mortgage secured by the same property plus the net cash payment made by petitioner.

²⁰ This amount represents losses of \$211,891,378 net of gains and related discount income of \$553,435 from petitioner's 1981 Resale/Refinance transactions.

²¹ This amount represents losses of \$129,119,673 net of gains from petitioner's 1982 Resale/Refinance transactions and related discount income of \$5,035,787 from both the 1981 and 1982 transactions.

In his notice of deficiency, respondent disallowed the deduction of the net losses claimed on petitioner's amended returns from the 1981 and 1982 Resale/Refinance transactions, and determined that petitioner "had recognized gains from the Resale/Refinance Program in the amounts of \$13,816,154 and \$14,521,949 which were not reported in the taxable years 1981 and 1982, respectively * * *." Those amounts were equal to the total original discount on the old mortgages that were paid off in such years and refinanced with new mortgages.

OPINION

I. *CMS Transactions*

The first issue for decision is whether petitioner realized recognizable losses in 1980 and 1981 from CMS transactions. The parties agree that if petitioner realized recognizable losses from the transactions, the amount of such losses is \$194,573,659 for 1980 and \$70,042,179 for 1981.

The parties' primary dispute centers on the proper interpretation of section 1.1001-1(a), Income Tax Regs. That section provides, in relevant part, that "Except as otherwise provided * * * the gain or loss realized from * * * the exchange of property for other property *differing materially* either in kind or in extent, is treated as income or as loss sustained." (Emphasis added.)

Respondent argues that the mortgages that petitioner received in the CMS transactions did not differ materially from the mortgages that it exchanged and that petitioner therefore sustained no losses from the exchanges. Petitioner argues that the mortgages it received in the CMS transactions did differ materially from the mortgages that it exchanged and that it therefore sustained recognizable losses from the exchanges.

The language in section 1.1001-1(a), Income Tax Regs., providing that gain or loss is realized from "the exchange of property for other property differing materially either in kind or in extent" derives from regulations issued in 1934. Those regulations provided that:

Except as otherwise provided, the Act regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*. [Regulations 86, art. 111-1, Revenue Act of 1934; emphasis added.]

The language has been carried forward essentially unchanged to present section 1.1001-1(a).

In determining whether property received by a taxpayer in an exchange differs materially from the property exchanged so that the exchange results in realized losses and gains, courts compare the two properties to determine whether the taxpayer has acquired "a thing really different from what he theretofore had." *Girard Trust Co. v. United States*, 166 F.2d 773, 774 (3d Cir. 1948); *Emery v. Commissioner*, 8 T.C. 979, 981-983 (1947), *affd.* 166 F.2d 27 (2d Cir. 1948). Gain or loss is realized from exchanges unless the properties exchanged are so similar that they represent the same property rights. *Emery v. Commissioner*, 8 T.C. at 982.

Applying these legal principles to the facts of this case, it is apparent that petitioner realized losses from the CMS transactions. The mortgages that petitioner received did not represent the same property rights as the mortgages that petitioner exchanged. As we found *supra*, the mortgages that petitioner received were obligations of different parties than the mortgages that petitioner exchanged. Additionally, the mortgages that petitioner received were collateralized by different properties than the mortgages that

petitioner exchanged. We consider both of these differences to be material differences. The fact that the mortgages that petitioner received have experienced different rates of foreclosure, prepayment, and delinquency since the CMS transactions took place confirms that the mortgages petitioner received were "really different from what he theretofore had."

In concluding that the mortgages that petitioner received were materially different from the mortgages that petitioner exchanged, we have considered the many similarities in the mortgages. Although we agree with respondent that the mortgages exchanged were similar in many respects, we disagree with respondent's conclusion that the similarities compel us to hold that there were no material differences in the mortgages. We consider it significant that respondent failed to produce any evidence that the similarities between the mortgages exchanged made it likely that they would be substantially identical from an economic perspective. Petitioner's economic expert, John P. Danforth, testified that the individual loans themselves, as well as the aggregate pools exchanged, could behave materially differently from an economic perspective, and that it would be an "incredible coincidence" for them to perform in an identical fashion. We think that this reflects reality and common sense.

The fact that the market values of the two pools of mortgages exchanged were the same, or almost the same, is not determinative. Current market value reflects an amalgam of the interest rate, the face amount and the maturity of the obligation. It is not necessarily a clear reflection of the value of the underlying security, the credit-worthiness of the borrower, or of varying local economic circumstances which may have future effect on these factors. The first mortgage bond of railroad A is not

the same property in kind or quality as the first mortgage bond of food processing company B, even though the two bonds may carry the same face amount, the same rate of interest, the same maturity, and may happen, at the moment, to be quoted at the same price in the open market. We hold that the similarities here do not result in there being no material differences in the mortgages.

Respondent asks us to apply the "mass asset rule" to the pools of mortgages involved in the CMS transactions and to ignore the differences between the individual mortgages contained in the pools. It has been held that the rule does not apply where the individual assets making up the "mass" can be and are separately valued, as here. *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966), affg. T.C. Memo. 1964-253; see *Boe v. Commissioner*, 307 F.2d 339, 343-344 (9th Cir. 1962), affg. 35 T.C. 720 (1961). Even if we were to accept respondent's argument that the rule, which is generally applied only when it is impractical to assign separate values or useful lives to individual assets contained in a group of assets, see, e.g., *Tomlinson v. Commissioner*, 58 T.C. 570, 581 (1972), affd. per curiam 507 F.2d 723 (9th Cir. 1974); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912, 923 (1961), affd. 309 F.2d 279 (3d Cir. 1962), applies in this case, the record simply does not support respondent's argument that the pools of mortgages exchanged in each of the CMS transactions did not differ materially. Danforth's testimony, as well as the actual economic performance of the pools exchanged, establishes that they were materially different.

Respondent next argues that section 1091²² precludes

²² All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

the recognition of losses realized by petitioner from the CMS transactions.²³ Section 1091(a) disallows the deduction of losses from the sale or other disposition of stock or securities when the taxpayer acquires substantially identical property within 30 days of the sale or disposition. Although it is uncertain whether mortgages constitute "stock or securities" within the meaning of section 1091, we need not decide the issue. For the deduction of petitioner's losses to be disallowed under section 1091, we must conclude that the mortgages petitioner exchanged were substantially identical to the mortgages it received. We conclude instead that the two pools of mortgages were substantially different.

Our conclusion that the mortgages petitioner received are substantially different from the mortgages that it exchanged is supported by our decision in *Hanlin v. Commissioner*, 38 B.T.A. 811 (1938), affd. 108 F.2d 429 (3d Cir. 1939). In *Hanlin*, a taxpayer had exchanged bonds issued by one Federal Land Bank for bonds issued by another Federal Land Bank. The bonds were each collateralized by different mortgages. Although the bonds

²³ Sec. 1091(a) provides:

(a) **DISALLOWANCE OF LOSS DEDUCTION.**—In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 165(c)(2); nor shall such deduction be allowed a corporation under section 165(a) unless it is a dealer in stocks or securities, and the loss is sustained in a transaction made in the ordinary course of its business.

had the same par value and price, and bore the same rate of interest, we held that they were not substantially identical. *Hanlin v. Commissioner*, 38 B.T.A. at 819-820.

In affirming our decision, the Court of Appeals for the Third Circuit recognized that debt instruments can differ due to, inter alia, different obligors and different collateral. Although the court was unable to conclude that the issuers of the bonds were different as the issuers were secondarily liable on each other's bonds, the court did conclude that different collateral underlay the bonds exchanged. The fact that different collateral supported the bonds exchanged prevented them from being substantially identical. *Hanlin v. Commissioner*, 108 F.2d at 431.

In this case we have already found that different properties collateralized the mortgages exchanged. In addition, the mortgages were obligations of different borrowers. In these circumstances, we hold that section 1091 does not apply to disallow the recognition of the losses realized by petitioner from the CMS transactions.

Respondent's final argument for disallowing the deduction of losses from the CMS transactions is that the CMS transactions "lacked economic substance and reality." We disagree with respondent's argument.

It is well settled that taxpayers are free to minimize their taxes by any legitimate means. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Nyhus v. Travel Management Corp.*, 466 F.2d 440, 448 (D.C. Cir. 1972). We have recognized that the deduction of bona fide losses may not be disallowed simply because petitioner was motivated by a desire to reduce its taxes. *Joseph E. Widener, Trust No. 5 v. Commissioner*, 80 T.C. 304, 310 (1983).

The losses that petitioner realized from the CMS transactions were from bona fide exchanges between unrelated parties. As we have found, petitioner had significant busi-

ness reasons for engaging in the transactions. In these circumstances, we reject respondent's argument that petitioner's losses from the CMS transactions "lacked economic substance and reality" and are not deductible. On the record presented here, we hold that the exchanges in which petitioner participated under the CMS program resulted in closed and completed transactions within the meaning of section 165 and section 1.165-1(b), Income Tax Regs., and that petitioner is entitled, under the provisions of sections 1001 and 1011, to tax recognition of the resulting losses in the amounts which the parties have stipulated.

II. *Resale/Refinance Transactions*

Petitioner argues that the step-transaction and substance-over-form doctrines apply to Resale/Refinance transactions and that they should be viewed as exchanges by petitioner of the original mortgage loans plus cash in return for the new mortgage loans. Respondent argues that regardless of whether the step-transaction doctrine applies, the substance of the transactions was consistent with their form and the original loans were repaid from the proceeds of the new loans, not exchanged for the new loans.

We disagree with petitioner's position on two major grounds. One, perhaps, is more procedural in nature; the second is substantive.

First. As we said in *Bolger v. Commissioner*, 59 T.C. 760, 767 n. 4 (1973): "the taxpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted." Taxpayers are entitled to attack the form of their transactions only when their tax reporting and other actions have shown an honest and consistent respect for what they argue is the substance of the trans-

actions. *Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985); *Illinois Power Co. v. Commissioner*, 87 T.C. 1417, 1430 (1986). In this case, as our findings show, petitioner's tax reporting and other actions have not shown such an honest and consistent respect for what it now claims to be the substance of the Resale/Refinance transactions. Although petitioner now argues that the transactions were taxable exchanges, it did not report them as such on either its original income tax returns or on its financial reports. As this Court stated in *Groetzinger v. Commissioner*, 87 T.C. 533, 542 (1986):

In applying the substance-over-form doctrine we are concerned with the intentions *at the time of the agreement* and economic realities *as then perceived by the participants*. * * * [Emphasis added.]

In this case, when the Resale/Refinance transactions took place, it is clear that petitioner did not perceive them to be taxable exchanges. We are accordingly disinclined to accept petitioner's attempt to recharacterize them by hindsight, and after it conceived that a tax advantage could be obtained.

Second. More importantly, we think that petitioner must fail here on the substance of the transactions which took place. As the facts in this case clearly show, the old mortgages in the Resale/Refinance transactions were paid off in full, and were replaced by petitioner's purchase of new mortgages, in different amounts, with different terms, and (in the case of Resale transactions) with new obligors. When an old mortgage was paid off, the note was marked paid and the lien securing it was released. At that point it disappeared, and there was nothing left which petitioner could "exchange" with the savings and loan lender for the new mortgage which had been created, except the cash which petitioner paid to acquire such new

mortgage. To try to create an "exchange" out of these transactions simply distorts the facts beyond recognition.²⁴

We concede that there was an interrelationship between the two transactions. Petitioner sponsored the program, and encouraged the local savings and loan associations to participate in it, for the valid business reasons which we have found. The lending savings and loan institutions were assured that if they placed new loans in conformity with the criteria laid down by petitioner, then petitioner would purchase such loans once made. This fact, however, cannot obscure the substance of the transaction, which was that the old loan in petitioner's hands was completely paid off, and a new loan, with materially different terms and frequently with a different obligor, was purchased. We think that here the form of the transaction, as petitioner originally treated it, corresponded to the substance, and that no exchange took place here, taxable or otherwise.

Having concluded that the Resale/Refinance transactions may not be viewed as taxable exchanges, we must next determine their proper tax treatment. Respondent determined that petitioner realized taxable gains to the extent that its bases in the old mortgages were less than the amounts repaid by the borrowers. We agree.

When a borrower obtains a loan from a lender and purports to use the proceeds of the loan to repay another loan from the same lender, there are two ways that the transaction can be viewed. The second loan can be viewed as merely a refinancing of the original loan, with the result that the original loan is not treated as having been repaid, or the second loan can be viewed as a separate loan, with

²⁴ We agree with respondent, contrary to petitioner's urging, that his answer cannot reasonably be construed as an admission that the transactions were taxable exchanges. -

the result that the original loan is treated as having been repaid. Whether the original loan is properly characterized as having been repaid is a factual question. *Buddy Schoellkopf Products, Inc. v. Commissioner*, 65 T.C. 640, 649 (1975). The crucial inquiry is whether the second loan is simply designed as a refinancing of the original loan, or whether the differences between the two loans are so great that the original loan can properly be characterized as having been repaid. *Schoellkopf, supra* at 649. In this case, as we have said, we have no difficulty in concluding that the original mortgages can properly be characterized as having been repaid.

In *Schoellkopf*, we held that an original loan could properly be characterized as having been repaid from the proceeds of a second loan from the same lender, the terms of which required a portion of the proceeds to be used to repay the original loan. In so holding, we relied on three differences between the second loan and the original loan. First, the second loan provided the borrower with new funds in addition to the funds used to pay the original loan, and was thus not simply a refinancing of the original loan. Second, the second loan had a different interest rate than the original loan. Third, the second loan had a different maturity date from the original loan. In this case, each of these three differences are present²⁵ and, in addition, there are other material differences between the original and new mortgages. As we found *supra*, the original mortgages were assumable, either by their own terms or because of petitioner's commitment not to en-

²⁵ The interest rates charged on the new mortgages were not merely a combination of the rates that had been charged on the original mortgages and the prevailing rates for the additional cash. The lenders were free to bargain for a higher rate than would be required by a combination of those rates, and they had an incentive to do so.

force due-on-sale clauses. The new mortgages were generally assumable only within one year of when they were made. In addition, most of the original mortgages were FHA and VA mortgages. The new mortgages were all conventional mortgages. Finally, in Resale transactions, which constituted most of the transactions, the obligor on each new mortgage was different from the obligor on each original mortgage. These many differences convince us that the original mortgages are properly characterized as having been repaid.

In sum, we hold that petitioner realized taxable gains when the original loans were repaid in full, in the amount that the sums repaid by the borrowers exceeded petitioner's bases in the loans, computed as provided in section 1001.

To reflect the foregoing and the concessions of the parties,

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, CHABOT, PARKER, SHIELDS, CLAPP, SWIFT, JACOBS, WRIGHT, PARR, WELLS, and WHALEN, *JJ.*, agree with this opinion.

NIMS, WHITAKER, COHEN, and WILLIAMS, *JJ.*, concur in the result only.

GERBER and RUWE, *JJ.*, did not participate in the consideration of this case.

APPENDIX C

The Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the tax year at issue, provided in pertinent part:

§ 165. Losses**(a) General rule**

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

§ 1001. Determination of Amount of and Recognition of Gain or Loss.**(a) Computation of Gain or Loss**

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken in account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of Gain or Loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

* * * * *

The Treasury Regulations on Income Tax (26 C.F.R.) provide in pertinent part:

§ 1.1001-1 Computation of gain or loss

(a) General rule

Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other allowances, and other items chargeable against and appli-

cable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).